# FINANCIAL MARKETS VOLUME EBULLIENCE: MAKING THE CASE FOR TONED DOWN MARKET ACTIVITY

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The recent past has witnessed tremendous growth of the Indian securities market, the financial derivatives market included. While celebrating this fact it is also pertinent to bear in mind the market fundamentals that underlie and their resultant capacities and limitations. In the context of the derivatives market which inherently is a zero-sum game such exuberance may not be justified. Juxtaposing 'winner' and 'loser' statuses in a derivatives market reveals a perfect equilibrium - 'gain-loss parity', an equilibrium that embeds a disequilibrium of gains. The vastly baffling world of the derivatives market and allied financial instruments easily dissuades one from attempting to define the contours of its functioning. In this article I make the case for a toned down market in the context of the derivatives market and presents a logical justification for it.

Let us consider the case of the derivatives market. The derivatives market activity is fueled by hedger-speculator activity along with arbitrageurs. By definition, hedgers are those who have opposing positions in the futures market and the cash market for the same underlying security/assets. Hedgers hold instruments to offset correlated risks in other activities. Hedger's position in the futures market offsets the profit or loss made against its corresponding position in the cash market. A profit in the cash market implicates loss in the futures market, such that losses countervail profits. For the individual hedger it's always a ' no profit no loss' situation, apart from transaction charges, no matter how the market moves. This is also the reason why individuals hedge securities held by them in times of extreme market volatility or ex ante uncertainties. Although hedgers are protected from any losses per se, they are also restricted from any gains owing to their hedging activity. Therefore, since a loss in the futures market of a hedger is counterbalanced by a profit in the spot market, the hedger isn't very likely to treat the loss borne in the futures market purely as a loss.

Consistent losses in the futures market may however deter the hedger from hedging as the perspective might then change to avoiding passing over gain making opportunities in the spot market which as a consequence would lead to restricted and constrained hedging activity. That said there are circumstances where hedging becomes more of a necessity and an optimality. In such events the role played by the speculator becomes vital.

Speculators are people who analyse and forecast futures price movement, trading contracts with the hope of making a profit. Speculators make bets or guesses on where they believe the market is headed. For example, if a speculator believes that a stock is overpriced, he or she may short sell the stock and wait for the price of the stock to decline, at which point he or she will buy back the stock and receive a profit. Speculators are vulnerable to both the downside and upside of the market; therefore, speculation can be extremely risky. While they put their money at risk, they won't do so without first trying to determine to the best of their ability whether prices are moving up or down. Speculators analyse the market and forecast futures price movement as best they can. They may engage in the study of the external events that affect price movement or apply historical price movement patterns to the current market. In any case, the smart speculator doesn't operate blindly. The main purpose of speculation, is to profit from betting on the direction in which an asset will be moving.

Speculators assume risk for hedgers. Speculators accept risk in the futures markets, trying to profit from price changes. Hedgers use the futures markets to avoid risk, protecting themselves against price changes. This is the ideal situation also the reason why derivatives as market products were invented in the first place.

There's a futures contract for a commodity or financial product because there are people who conduct an active business in that commodity. For example, there's a cotton futures contract because there are cotton producers who sell cotton and

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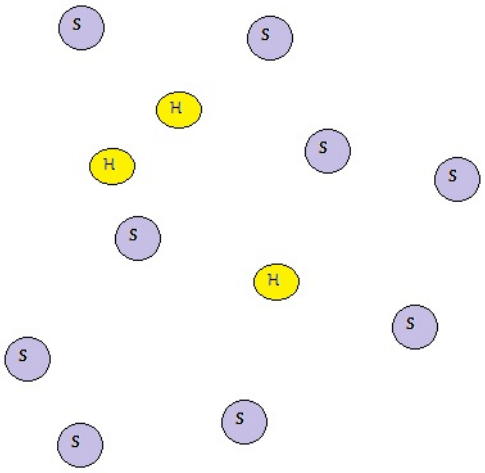
companies that buy cotton. The hedger plans to buy (sell) a commodity, such as cotton, and buys (sells) a futures contract to lock in a price and protect against rising (falling) prices. The need for risk management that futures can meet holds true for all markets, including financial markets. Internationally, companies hedge their foreign exchange and interest rate exposures. Similarly, hedge-fund managers hedge stock fund risk.

One of the major functions of the financial markets is to convey appropriate price signals to the economy. There is a social value of price discovery. A market economy could not function in the absence of prices, but that doesn't entail beneficialness of more price discovery or excessive non required liquidity. Market manipulation, front running and such other malpractices that lead to loss of confidence in the markets still loom large. They enhance the powers of certain market players to manipulate the market for at least as long as the market doesn't figure it out. But even if the distortion in the market is limited, costs can be imposed on others in their attempt to decipher how the market might be manipulated. Again, attention is diverted away from understanding the fundamentals of the economy—to acquiring information that might make the economy perform better and more efficiently.

Any digression from the ideal situation, possibilities of which abound, would lead to an interesting scenario—where the number of speculators exceeds the number of hedgers hugely.

SCENARIO WHEN NUMBER OF SPECULATORS IS IN EXCESS COMPARED TO NUMBER OF HEDGERS




| TRANSACTING PARTIES<br>ASSUMING 1 TRANSACTION<br>EXECUTED BY EACH PARTICIPANT<br>OF EQUAL QUANTITY |
|---|
| H—S |
| H—S |
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| S—S |
| S—S |
| S—S |

SPECULATORS END UP TRADING AMONG THEMSELVES

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The speculators would end up trading among themselves when the above scenario builds up. In such case the very nature of the derivatives market would fetter such activities and bring down the level of both the excessive speculating activity and the number of speculators to an optimum.

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Here's a brief explanation why (considering the Futures market as an instance) -

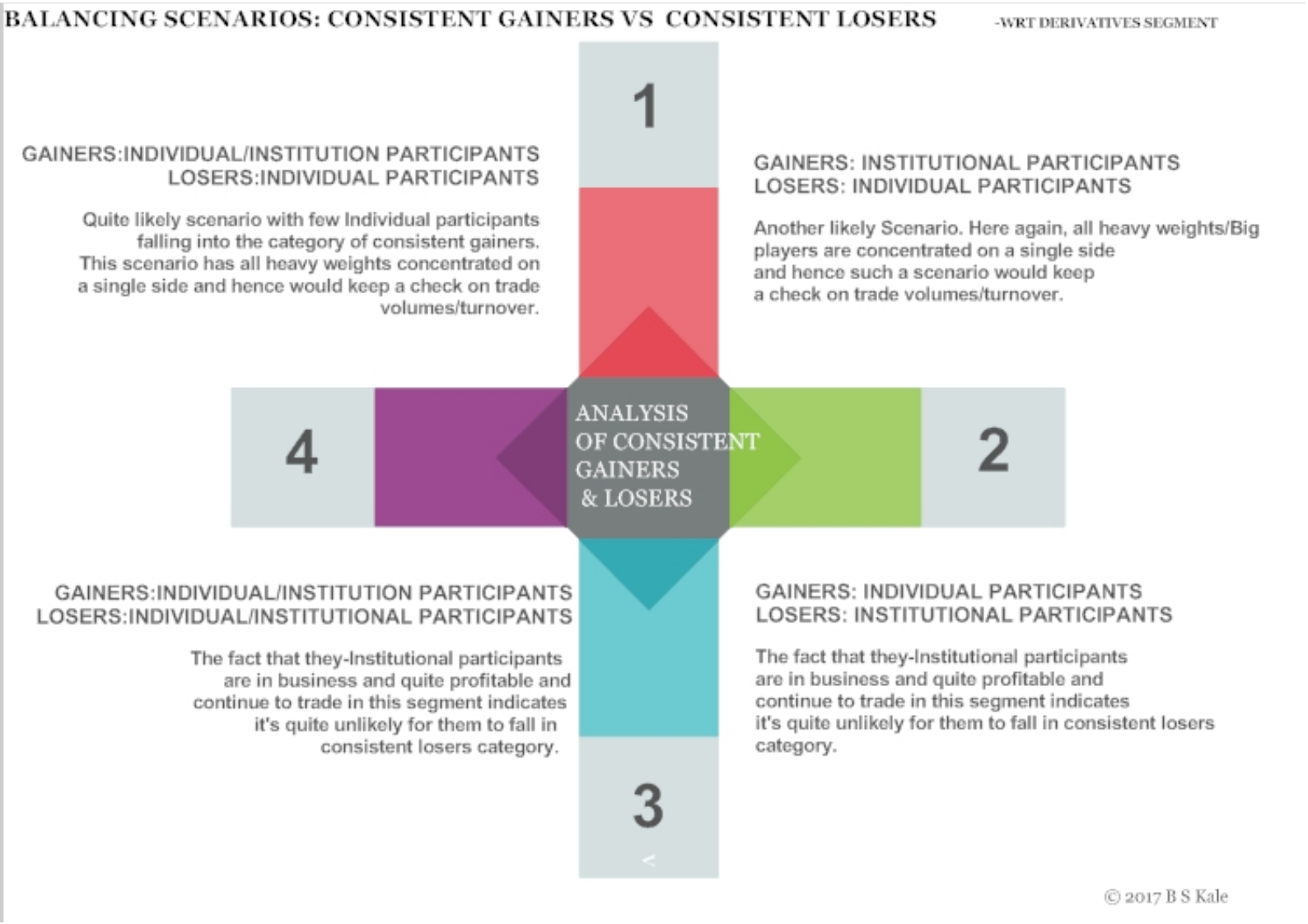
As with all zero-sum games, in futures market it all boils down to the 'Winners' and the 'Losers' at the Futures expiry. Futures price and underlying price of the security converge and the total of all profits gained by Gainers equals the total of all losses incurred by Losers.

If today's Gainers—institutions or individuals—are to be tomorrow's Losers (institutions or individuals) and vice versa, it makes it a zero-sum game for all; but if professional/consistent 'Winners' are to continue to win then 'Losers' have to continue to lose. More often than not losers would quit trading post a series of losses/zero-sums making it impossible for 'Winners' to win. No Losers would mean no Gainers.

Rate at which market can replenish losers in equal capacity of lost numbers, money flows and volumes is quite limited. Popular reasons for market participation such as saving, portfolio re- balancing, investment or making money from markets do not justify the observed level of trading activity- the huge volumes.

Professional trading institutions may well be aware of the zero-sum nature of the markets & would only enter when they have an edge over others. Apparently, equal no of losers are to be expected in terms of money flows, volumes et al.

Laymen investors/traders tend to be (as also are advised to be)cautious in putting money into the markets thus restricting profits that can be made by professionals.


BALANCING SCENARIOS: CONSISTENT GAINERS VS CONSISTENT LOSERS
-WRT DERIVATIVES SEGMENT
1
GAINERS:INDIVIDUAL/INSTITUTION PARTICIPANTS
LOSERS:INDIVIDUAL PARTICIPANTS
Quite likely scenario with few Individual participants falling into the category of consistent gainers. This scenario has all heavy weights concentrated on a single side and hence would keep a check on trade volumes/turnover.
GAINERS: INSTITUTIONAL PARTICIPANTS
LOSERS: INDIVIDUAL PARTICIPANTS
Another likely Scenario. Here again, all heavy weights/Big players are concentrated on a single side and hence such a scenario would keep a check on trade volumes/turnover.
4
ANALYSIS OF CONSISTENT GAINERS & LOSERS
2
GAINERS:INDIVIDUAL/INSTITUTION PARTICIPANTS
LOSERS:INDIVIDUAL/INSTITUTIONAL PARTICIPANTS
The fact that they-Institutional participants are in business and quite profitable and continue to trade in this segment indicates it's quite unlikely for them to fall in consistent losers category.
GAINERS: INDIVIDUAL PARTICIPANTS
LOSERS: INSTITUTIONAL PARTICIPANTS
The fact that they-Institutional participants are in business and quite profitable and continue to trade in this segment indicates it's quite unlikely for them to fall in consistent losers category.
3
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Taking cognizance of the above facts, one can conclude it is the very nature of the zero-sum part of the market game to practically not allow for huge volumes or continued market participation of all of its market participants especially the non–gainers.

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Interestingly, if the above scenario (i.e. the disproportionate rise in number of speculators as compared to hedgers) builds up it would automatically make sure consistently losing/non-gaining parties quit.

It's questionable, however, if that doesn't happen i.e. if number of speculators is not automatically brought under check—and if it remains to be the case for extended periods of time. Unless one was to exclude altogether any monetary incentive for market participation—making the source of market funding hazy, which in itself insinuates a possible market manipulation.

Every other factor accounted for, it is still not possible for the derivatives market to sustain itself with disproportionately huge volumes—its very nature (zero-sum) does not allow that. Technically, such discrepant situation is not possible without a maneuver. The market regulators ought to dig into the details and causes of such discrepancies. Such huge volumes have no associated quantifiable value, at least not for the sake of social welfare or for the interest of fair and equitable functioning of the markets. It's time the markets tone down their ebullience for good.

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